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"We are all aware the staying power of this expansion is being tested, particularly in the United States. Even during the years of growth our performance has been marred by massive imbalances, domestically and internationally, low savings, sluggish investment, unsustainable dependence on foreign capital, and slow productivity growth. We should clearly recognize most of those difficulties lay beyond the reach of monetary policy.

Paul Volcker, The Triumph of Central Banking
1990, per Jacobson Lecture

HIGHLIGHTS

What's wrong with Mr. Greenspan's policy; the first attempt at gradualism by the Fed? It is based on two dangerous and false assumptions. Because of that, his "stability policy" will probably end up as the wildest "stop-and-go" that the United States has ever seen.

The long economic recovery was not one long straight expansion. In retrospect, there were three or four distinctly different phases. External factors played a significant role. Despite the popular perception, the U.S. economy is not impervious to a cumulative downturn.

Britain's entry into the European Monetary System (EMS) is an act of desperation. The utter failure of this tactic to strengthen sterling is a humbling foreshadowing of what is to come for the currencies of all the other deficit countries.

The shocking reality is that so few people have woken up to the devastating consequences of an enormously significant tidal change in world capital flows. It is the single biggest development in the cumulative procession of post-war financial history.

Very few people realize the lion-force consequence that this change in capital flows has for the economies, markets, and currencies of the deficit countries. What's worse is that the past environment of persistent deficits has left a powder-keg of residue: an unprecedented build-up of foreign-held debt predominantly in the form of tradable market securities.

Should this potentially volatile storehouse of past excesses ever heave into motion . . . in other words, reverse motion . . . the negative impact on financial markets would be unthinkable.

In face of the real-life gravity of the problems we see in the U.S. and other deficit countries, there is still too much complacency and nonchalance despite the depths of the bear markets in stocks and bonds seen to date.

The relentless fall of the U.S. dollar, the collapsing share market, and the weak bond market reflects growing pessimism but it's only the beginning recognition of the awful underlying fundamentals. Voodoo economics has finally come to wits end.

THE HARD LANDING HAS ARRIVED

In his most recent testimony before Congress, Fed Chairman Alan Greenspan caused some amazement by drawing a distinction between a standard recession, defined as two consecutive quarters of negative real growth, and a much more serious proposition: "a process of deterioration in which events feed on each other and induce the economy into a cumulative decline."

What was notable, in our view, was not the statement itself but rather the amazement that the comment received. What Greenspan alluded to was the difference between a "soft" and a "hard" landing for the economy, financial markets and the currency. That people should find the possibility of a hard landing amazing at this late stage is indeed amazing.

It's always been our view that Wall Street makes far too much of the question of whether or not the economy shows any traces of positive growth. In reality, the difference between mini-recession and mini-growth is trivial. It's a distinction that only matters for the forecasting sweepstakes. What does matter, however, is a slump that threatens to deteriorate into a downward spiral.

THE KEY QUESTION: A DEEP RECESSION OR NOT?

Obviously, though, Mr. Greenspan did not intend to direct the discussion from the trivial to the important. Entirely to the contrary, he counselled that such a scenario was not in sight. The primary aim of his comments was to warn the markets that the Fed would delay an aggressive easing as long as it possibly can.

If the Fed thinks there is reason to believe that the downturn may remain short and shallow then the following chilling thought becomes a possibility: even a net decline in real GNP might not prompt a vigorous response from the Fed.

On the surface, Greenspan's "hold-steady" scenario sounds reasoned and non-heretical. Yet, for America, it is a radical departure from the past. In the entire post-war period, it has been a virtual rule for the Fed to slash interest rates in rapid succession following the first signs of weakness.

A DEPARTURES FROM THE PAST: GRADUALISM

The last time a major monetary stimulation occurred was in the third quarter of 1984 under the direction of Paul Volcker. The Fed cut the fed funds rate by four full percentage points within a period of four months. The rate dropped from 12% to below 8% between August and December. But what a difference there was in the underlying conditions of then versus those of today.

Real GNP grew by 6.8% in 1984 although slowing sharply in the course of the year. Growth in the first quarter was 10.1%, 7.1% in the second, 3.6% in the third and 4.6% in the fourth (all taken at annual rates). Inflation, as measured by the consumer price index (CPI), was running at 4% when the Fed began to ease. As it turned out, contemporary data at the time had misleadingly pointed to greater economic weakness.

Contrast the experience of 1984 with the present state of the United States: real GNP growth was 0.4% in the last quarter and an average of 0.8% over the previous three quarters. Yes, Mr. Greenspan has eased in the face of a weakening economy having started well over a year ago. The point of reference though is an economy that is sliding much faster and from a much lower plane of growth than in 1984. It has taken Greenspan a full 15 months to lower the fed funds rate from

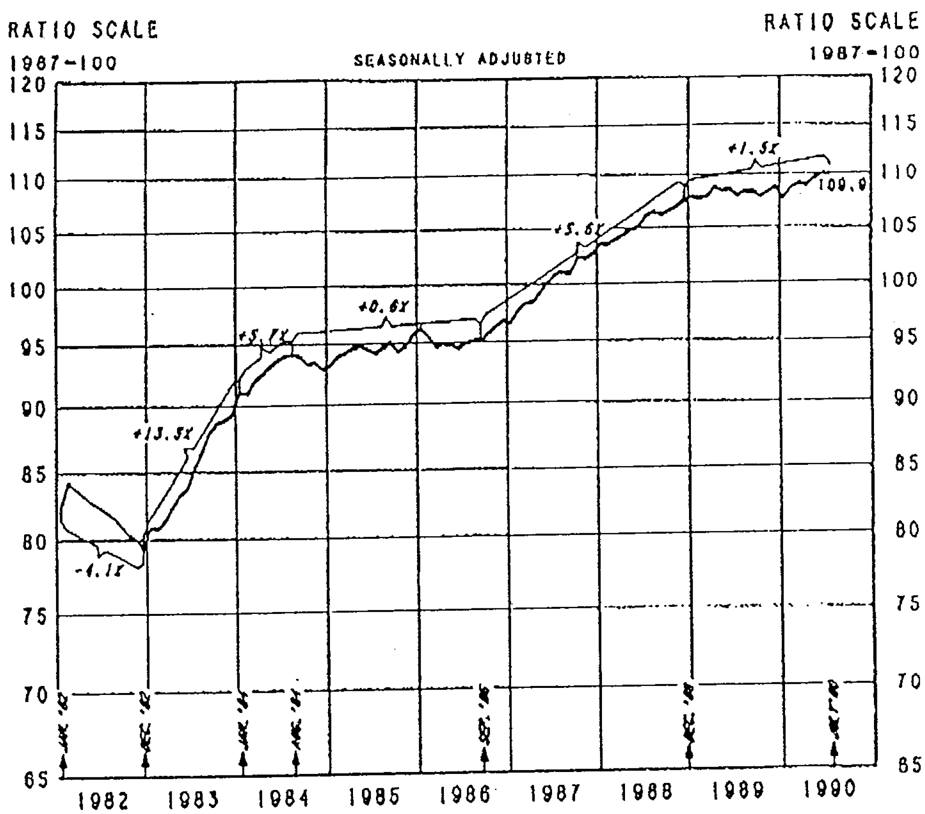
nearly 10% in mid-1989 to 8%. He is clearly betting on gradualism.

It's the first attempt at gradualism for the Fed. Even more remarkable is the openly declared willingness to stick to a steady path even in the face of a temporary net decline in real GNP. Yet, we should remember, that Mr. Greenspan also articulated the limits to his "gradualism": the recognition of a "cumulative downturn feeding on itself."

We have never doubted Mr. Greenspan's commitment to significantly reduce U.S. inflation. What we have sternly questioned is whether he is able to deliver . . . with or without gradualism.

Just what has Mr. Greenspan been trying to do these last three years? The aim of his gradualist monetary policy was to maintain economic growth at or around 2% (a little below growth potential) while hoping to cool the price climate. The first thing to realize at the present is that his policy has so far failed completely in both respects. While economic growth has slowed to a crawl of barely 1% from 3.4% in 1987 and 4.6% in 1988, there is no sign of any moderation in consumer price inflation. The consumer price index was still running at nearly 5% even before the oil shock. The truth be known, GNP growth is actually at its lowest since 1982 and inflation is at its highest.

UNITED STATES: INDUSTRIAL PRODUCTION GROWTH



Source: Federal Reserve Bank of St. Louis -Annual rates of change for periods indicated.

A FOUNDATION ON FALLACY

What's wrong with Mr. Greenspan's policy? The short answer is that it is based on two dangerous and false assumptions. Because of that, his "stability policy" will probably end up as the wildest "stop-and-go" that the United States will ever have seen. The first mistake is the underestimation of the underlying inflationary bias of U.S. economy due to increasing structural causes, not cyclical monetary dynamics. The second mistake is that the Fed overestimates the economy's resilience. The two illusions apparently stiffen his resolve to hold out in his fight against inflation even though the economic and financial data are rapidly worsening.

To begin with, we have to recall from past experience that monetary restraint at first impacts production more than prices. Prices are affected only after a considerable delay. It is not unusual for inflation to continue rising against the backdrop of a weakening economy. Still, the lack of any improvement in the U.S. inflation performance even though the economy has been steadily weakening for two full years is rather ominous.

Conventional wisdom says that inflation is purely a monetary phenomenon and is basically due to the fact that demand for goods and services exceeds supply when fuelled by excessive money growth. From that perspective, all that is needed to rein in money and credit growth, therefore, is to slow demand growth relative to supply growth.

We have often emphatically expressed our view that the U.S. inflationary bias stems from deeper causes than just money supply. It is imbedded in powerful political, social and economic forces that are beyond the reach of monetary policy.

The root malady is the abysmal rate of capital formation and the related collapse in productivity growth that began to occur in the 1970s. That keeps the U.S. price system under permanent cost pressure even though real wages have been falling. Gross weakly earnings measured in constant dollars have declined almost continually during the past 18 years for a total decline of 16-17%. Yet, despite falling real wages inflation remains stuck at 4-5%. It is not by accident that the two major countries with the least inflation - Japan and Germany - have the strongest savings, investment and productivity performance. These are the basic things that check inflation.

Despite the important fundamental nature of these structural issues, all major econometric models currently used in the United States for forecasting and policy analysis either play down or completely ignore the critical role of productivity in determining the economic environment.

INFLATION: A QUESTION OF MIND OVER MATTER?

Economists have become obsessed with the idea that the persistent inflation springs mainly from entrenched inflationary expectations. From that perspective, all that is required to get the same low inflation rates as Germany and Japan is for the Fed, the Bank of Canada or the Bank of England to win the same credibility as uncompromising inflation fighters as the Bundesbank. As their "credibility" comes to fruition over time, investors, workers and businesses cease to demand the customary inflation premiums in interest rates, wages and prices, and voila . . . non-inflationary growth falls into place.

For all the Anglo-Saxon countries, it is not exaggerated to say that the main object of monetary policies has been to change market expectations. Reaganomics, after all, was all about expectations and psychology. Unfortunately, this "voodoo" economics has become a substitute for sound policies. Low inflation over the long-run depends on far more than just the judicious control of money supply and expectations. Crucially, low savings depends on the objective realities of savings, investment and productivity growth.

The obsession with expectations and the related psychological manipulation is not only nonsense, worse than that, it is highly dangerous nonsense because it deflects attention from the true causes of high inflation in these countries. In reality, it's all been gimmickry to mask the continuation of bad policies. By pretending that deficits don't matter, whatever their size, policy administrators have stuck theirs head into the sand preferring to be oblivious to any long-term dangers.

Britain's entry into the European Monetary System (EMS) is a typical case. What Britain direly needs is higher savings and investment. The purpose of tying sterling to the D-mark works diametrically opposite to that need. The recent manoeuvre is nothing more than an attempt to attract more foreign capital at lower rates. The trouble is that this tends to stimulate consumption at the expense of investment.

THE FABLE OF THE ROBUST ECONOMY

In principle, the "new era" notion that recessions have gone the way of the dodo bird is an upshot of the unusual longevity of a long economic upswing that started in 1982. The long recovery period generated two myths: first, that the U.S. economy is tremendously robust; and second, that the Fed can readily turn a around a sliding economy.

But what was it that actually made this the longest economic expansion in the post-war period despite mammoth trade and budget deficits?

In the general euphoria, economists never bothered to explore this most important question. A host of sweet-sounding and fabricated theories were offered as the answer. The common thread of all these theories was that the long absence of a recession must be attributable to some beneficial development in either the U.S. economy or its policies or both. The most comforting theory of all, certainly, was based on nothing more than faith: that being faith in the perspicacious powers of the Fed.

The first thing to correct is the notion that the long recovery was one long straight expansion. It was not. In retrospect, there were three or four distinctly different phases. External developments played a significant role.

A FOUR-PHASE RECOVERY

The first phase covers the six quarters from the end of 1982 to mid-1984. It produced the bulk of the Reagan recovery with a jump in industrial production of almost 17%.

The second phase between mid-1984 and the autumn of 1986 lasted nine quarters. Faced with a

sharply weakening economy, the Fed reverted to an aggressive easing that Fall. Over the period, the fed funds rate was cut drastically from 12% to 6%; most of the decline occurring in the fall of 1984. Accentuating this sharp easing was a nose-diving oil price - falling from $30 to $10 a barrel - along with a slumping dollar.

The vigorous monetary easing had prompt effects in the form of a roaring credit expansion, fuelling a boom on Wall Street with skyrocketing bond and stock prices. The country luxuriated in unprecedented wealth effects. But the grandiose impact on the financial markets contrasted conspicuously with only minute effects on the real economy. Despite massive monetary and fiscal stimulation, economic growth stayed sluggish with industrial production rising by altogether no more than 0.6% in the space of the nine quarters.

Next to the third phase. It covered the three-year period between 1986 to mid-1989 and was marked by a slow and gradual monetary tightening that ended with a fed funds peak near 10%. Paradoxically, though, this time the real economy took off despite the background of a monetary tightening. Real GNP growth accelerated from 2.7% in 1986 to 3.4% in 1987 and 4.6% in 1989.

The fourth phase, as we see it, has been unfolding since mid-1989. The outstanding features of this phase have been a progressive lowering of the fed funds rate from 10% to 8% and an unresponsive, progressively weakening economy.

All in all, we would say that the vaunted recovery has been an extremely mixed experience, full of surprises, contradictions and inconsistencies. However, all of these important distinctions appear to have been forgotten. What remains as the general perception is the image of an exceptionally long and continuous expansion which in turn has been taken as proof-positive of a U.S. economy bristling with resilience and vigour, the result of excellent policies and stewardship. It's been that misconception that has bred the present complacency.

Our opinion is at radical odds with the prevailing rosy and complacent view. The long upswing is testament to neither claim - perfect policies nor venerated vigour. To support that view, we have to delve in for a closer look.

THE REAL UNDERPINNING TO THE ECONOMIC LEGEND

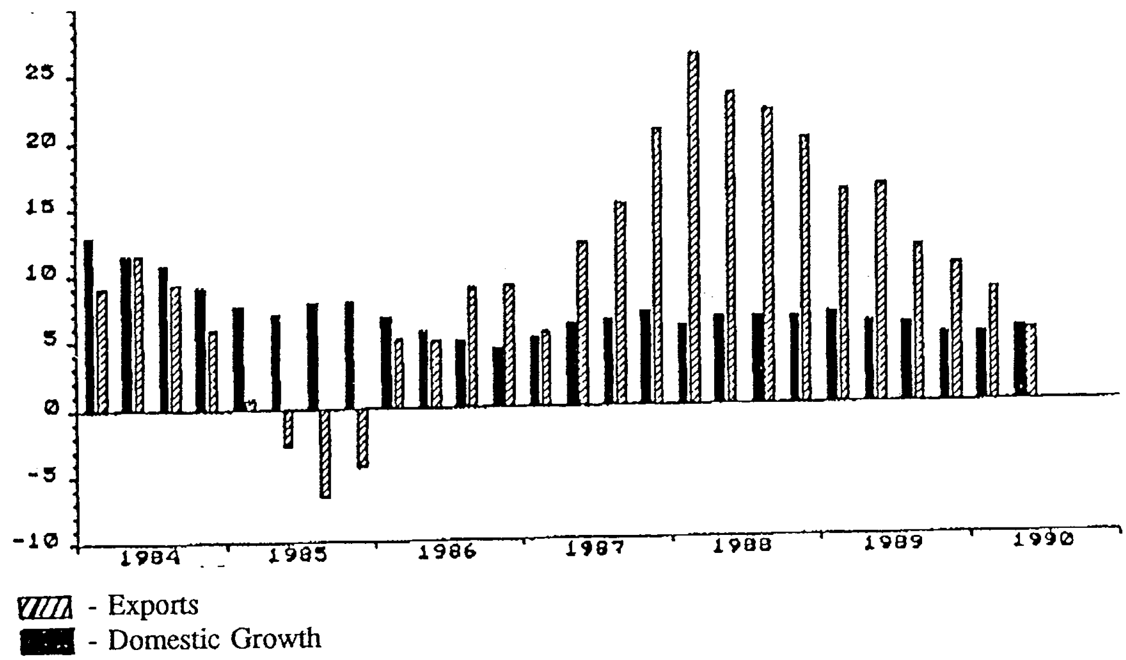
For two years, in 1985 and 1986, the U.S. recovery was in danger of aborting. It had failed to fully respond to a massive monetary and fiscal stimulation. At long last, in late 1986, economic growth picked up again lengthening the expansion for another three years. But what really caused this pick-up? Exactly what was it that saved the U.S. recovery at that time? That's the crucial question, because the answer points to a major deceiving misconception.

Of course, for most observers, the recovery of late 1986 was taken as proof of an invincible economy full of resilience and an interminable will. Here we find a great error. What really happened was that America - for the first time ever - enjoyed an export-led recovery marked by a mix of two propelling forces: a drastic dollar depreciation (dropping against the D-Mark from DM 3.45 to DM 1.72) and a massive monetary stimulation in the rest of the world triggering a virtual demand explosion in Europe and the Far East. By the beginning of 1987, a synchronized boom was

under way throughout the industrialized countries outside of the United States that spilled over into a U.S. export boom. The last recovery, in other words, was not a domestically generated variety but rather an external one.

The following chart illustrates the dominating role of exports in the post-1986 upswing and also the progressive weakening that has encroached since early 1988.

UNITED STATES: GNP GROWTH COMPONENTS
NOMINAL RATE OF GROWTH



Source: Datastream

An export boom, of course, is something that is very positive. The critical point to see, though, is the occurrence of an extraordinary confluence of favourable external conditions. A by-product of the desperate salvage effort by foreign central banks to stem the dollar's steep decline was a slashing of their domestic interest rates. That was only one side of the equation. In the process, the foreign central banks were additional buyers of dollars like there was no tomorrow.

While private capital inflows into the United States had dried up, foreign central banks stepped into the void and purchased more than $150 billion worth in the space of a little more than a year. Domestic money supply was boosted in these countries through these dollar purchases, thus overstimulating their markets and economies and drawing in sharply higher levels of imports. The combination of massive dollar purchases and an foreign import boom proved to be a truly gigantic rescue operation for the U.S. economy and dollar.

All of that's history, of course. It's essential to have a proper knowledge of that history, though, to fully appreciate how misplaced the current complacency about the U.S. economy really is. Reviewing the long upswing, it is most important to see that the two main factors that helped to

propel or sustain growth are no longer in prospect. In the second phase of the four-stage U.S recovery, it was only a massive monetary stimulation that was barely enough to keep the economy above water. In the third phase, only via a massive foreign stimulation did growth accelerate through export growth.

Now, as the fourth phase plays out, there is prospect for neither stimulant. Instead, what we see is a slow-motion monetary policy and a generally weakening world economy.

MORE COMPLACENCY THAN ANXIETY

Recently, we've read a lot of comments that confirm growing pessimism in the United States. We wonder, though, about the depth of that pessimism. Just a few months ago, most forecasters excluded the possibility of a recession. Now, there is a widespread belief that the economy is likely heading for one.

But lo and behold, what they see is a mild, shallow recession - "*extremely mild, the mildest since the 1960s*" to quote the President of the National Association of Manufacturers (NAM).

Do forecasters of a mild, shallow recession express pessimism or optimism? Compared to the prior euphoria, that may well qualify as pessimism. Relative to what is in store, however, they may yet prove to be wildly optimistic in our view. In an article, The Great Slump of 1930, Keynes wrote that before the disaster "*the man in the street had been lacking a reasonable anxiety*". Actually, Wall Street and the economics profession were then even more oblivious of danger than the man in the street.

In a way, the same can be said about America today. The world has been slow to realize that America and some other countries are living in the shadow of the greatest economic and financial crisis of the whole post-war period.

To be quite frank, relative to the gravity of the problems, we still see more complacency and nonchalance than anxiety. But what about the relentless fall of the dollar, the collapsing share market, and the weak bond market? Isn't that proof of growing pessimism? For us, it's all only reflects the beginning recognition of the awful underlying fundamentals. Voodoo economics has finally come to wits end.

BRITISH SELF-DELUSION

You can fool people most of the time, but you can't fool them all of the time. That old saying crossed our mind when we saw what happened in the wake of Britain's entry into the European monetary mechanism.

The British were cocksure that the EMS (European Monetary System) entry against the background of large interest-rate differentials between German and British short-term rates would lead to an immediate avalanche of foreign money into London. As a result, sterling would quickly rise to the top of its band, which would allow - if not require - further interest rate cuts during the run-up to the election.

It seemed like such a smart game plan: you tie the ailing pound to the sound D-mark and in due time one reaps the benefit of lower German interest rate levels.

We do realize that there are quite a few proponents in Britain who seriously hope and believe that a quasi-fixed exchange rate system will serve to have the good effect of imposing monetary, fiscal and wage discipline. After all, those are the general conditions of a stable exchange rate. That may be how a system of exchange rates used to work during the 1970s and 1960s. However, what we have observed during the past decade whether worldwide or within the European Monetary System (EMS) is the exact opposite.

As international investors begin to chase the currencies that offer the highest nominal interest rates - regardless of differences in inflation rates - the resulting capital flows completely pervert the exchange rate system. For years, the D-mark had been under downward pressure with its low interest and inflation levels while high-yield, high-inflation currencies with huge external deficits were driven up.

The end result is that fundamentally strong currencies are chronically undervalued with interest rates levels artificially higher than they should be and fundamentally weak currencies are overvalued with rates artificially lower than they would have been. Rather than imposing discipline, pegging a currency fosters indiscipline in markets eager to finance limitless deficits.

Given the opportunistic lowering of the bank rate from 15% to 14% on the heels of the entry into the EMS, Mr. Major, the British Chancellor of the Exchequer, had the chutzpa to reveal it transparently as a soft option. He clearly is banking on a repeat performance of Nigel Lawson's tactic of shadowing the D-Mark in 1987 through 1988 and the similar recent experiences of the peseta and the lira.

After a brief bout of optimism lasting less than a day, markets have come back down to earth. The sobering view prevails that nothing has really changed in terms of British economic conditions. If such a disappointing market response of the markets persists, it may cause growing embarrassment for the government since it would exclude the option of further interest rate cuts. It would be outright disastrous for market psychology if the government would soon have to defend a falling pound again.

Why has the whole tactic misfired so badly? What's the difference between today and 1987 and 1988 when the pound soared so responsively to repeated reductions in interest rates? The obvious difference has to do with the state of the economy. Then, the U.K economy was overheating; today it is hovering on the edge of recession. Viewing matters from this perspective, the pound appeared to have strong underpinnings in the former experience, while today, the linking of sterling to the EMS smacks of weakness and desperation. The immediate cut in the base rate only served to confirm that case.

There may be another important reason for Britain's EMS move. It has to do with the drastic change in the international liquidity situation. Today, hot money is in much shorter supply than in 1987-88 when central banks flooded the world markets with liquidity through their massive dollar purchases.

To be sure, the desiccation of international hot money pools has grave consequences for other currencies and not only the pound. This new environment makes it increasingly difficult to finance current-account deficits. As a result, economic fundamentals will emerge to reassert their influence on currencies.

THE HIGH COST OF CAPITAL IMPORTS

Surveying recent trends in the United States, Britain, Canada, and Australia, we are reminded of a comment by economist Joan Robinson on the merits of capital imports. She referred to the excessive capital imports of the developing countries as follows: "*Whether capital imports are a good bargain or not depends upon the nature of the use to which the funds are put. If they merely permit an excess of consumption over production, the economy is on the road to ruin.*"

The debt orgy of the developing nations lasted fully eight years, somewhat longer than the feeding-frenzy of the Anglo-Saxon countries. The slogan then was: "Debt does not get repaid: debts get rolled over." Despite the wisdom of the day, markets that had previously lavished credit on these countries clammed shut within the space of a few short months in 1982. All of a sudden, debt could no longer be rolled over.

In hindsight, it's perfectly clear what pushed the developing countries against the wall so quickly. These countries were crowded out of the international markets by tight money, high interest rates and soaring credit demand in the United States.

An obvious parallel to that predicament now confronts the new debtor countries of the 1980s. The foreign capital flows that have functioned to finance the deficits of these countries - mainly from Germany and Japan - are now being diverted into other channels. Germany needs the capital to revive and rebuild East Germany while Japan's huge portfolio outflows have been cut short by a domestic liquidity squeeze.

The shocking reality to us is that so few people have woken up to the devastating consequences of this enormously significant tidal change in world capital flows. It is the single biggest development in the cumulative procession of post-war financial history. Very few people realize the lion-force consequence that this change in capital flows has for the economies, markets, and currencies of the deficit countries.

What's even worse is that the past environment of persistent deficits has left a powder-keg of residue: an unprecedented build-up of foreign-held debt . . . and one shudders to think predominantly in the form of tradable market securities. Should this potentially volatile storehouse of past excesses ever heave into motion . . . in other words, reverse motion . . . the negative impact on financial markets would be difficult to quantify. Three years ago, in the dollar crisis of 1987, a large scale version of this was already witnessed. In the meantime, excesses have cumulated to even greater imbalances.

SUMMARY CONCLUSIONS

In Germany, it is customary to say on a occasion that sentiment is either worse or better than the

underlying situation. When we compare the sentiment in the United States, Britain and a few other countries with their grim prevailing economic and financial realities, we can say that applies without a moments hesitation. While general sentiment may have deteriorated, it is still far too optimistic.

To this point, markets have only grudgingly ceded their favourite pet theories. First, it was never a landing and then a "soft landing". Now the favourite refrain has become a "short and shallow" recession and nothing worse. For the most part, the thought of a "cumulating downturn" remains both unthinkable and unprintable.

For months now, every single GNP component and economic indicator displays progressive weakening. Consider the trend of employment growth which crucially determines income growth. The employment increase in the first nine months of 1990 of 400,000 compares abysmally with that of 1989 and 1988 of 2.34 and 2.54 million, respectively. What's even worse, is the relative sectoral changes. Manufacturing jobs are down almost 500,000 while jobs in health care and local government are up by more than 500,000 each.

Not only is the economic news rotten, even more distressing are the drastically deteriorating conditions of the underlying financial and economic fundamentals. Among the numerous negative factors we count at least nine factors worthy of serious concern.

> <ins>First</ins>, the U.S federal budget deficit is soaring from $150 billion toward $300 billion and higher. That's far more than the total available private sector savings of individuals and corporations. Their combined savings amount to approximately $230 billion.
>
> <ins>Secondly</ins>, corporate profit margins are collapsing and business cash flows are shrinking sharply.
>
> <ins>Thirdly</ins>, during the last two years productivity growth floundered at dead zero while wages rose at a rate of 5%.
>
> <ins>Fourthly</ins>, the U.S. trade deficit has again begun to rise due to the sharp rise in the oil price. Last year's oil imports totalled $52 billion. A sustained doubling of the oil price would feed through commensurate increases in the import bill. Furthermore, export growth has been slowing and may be on the verge of actually declining.
>
> <ins>Fifth</ins>, the widespread over-indebtedness of corporations and consumers adds an element of chronic demand exhaustion to the stew.
>
> <ins>Sixth</ins>, the U.S. economy has been structurally undermined over a long period. Investment has suffered at the hands of over-consumption.
>
> <ins>Seventh</ins>, a real estate glut of monstrous dimensions has caused prices to plummet in many areas of the country thus causing consumer confidence to sink to near decade-lows and impairing financial balance sheets.
>
> The <ins>eighth</ins> consideration is that all of this is occurring at a time of a quaking financial

system and an S&L crisis.

The ninth and most destabilizing element of all is an international liquidity crunch and a change in the polarity of world capital flows. The great suppliers of world liquidity - Germany and Japan - are retrenching and appropriating capital for themselves.

Considering the multiplicity and nature of the problems, America is heading into the severest recession of the post-war period. The list of negative influences on the U.S. economy is unprecedented in scope, type and severity. The key point to recognize is that the problems are not a harmless and short-term cyclical variety but rather are the worsening manifestations of a long-term secular deterioration that - like a termite infestation - undermines and weakens the entire superstructure of the of the U.S. economy.

On top of it all, as capital inflows stop and/or reverse, deficit nations find themselves nakedly exposed to a double liquidity crunch, both internal and external. Finally, true underlying fundamentals will come to bear on their currencies, financial markets and economies.

The stage is set for a "stabilization crisis." Unfortunately, the financial markets - especially currencies - will suffer the brunt of the fall-out. The current decline of the U.S. dollar is part of a chronic long-running phenomenon that very few have yet come to recognize. There may be lurching drops or soft fades but the outlook for the U.S. dollar seems immutable: the U.S. dollar is in the train of long-running bear market as far as the eye can see.

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